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TAXATION OF HOMEOWNERS ASSOCIATIONS UNDER THE TAX REFORM ACT OF 1976

With the passage of the Tax Reform Act of 1976,[1] Congress liberalized the taxation of homeowners associations.[2] These associations may now elect[3] a tax-exempt status[4] on income derived from member assessments,[5]

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[1] Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[2] *Id.* § 2101, 90 Stat. 1897 (codified in I.R.C. § 528). A homeowners association supplies services and enforces agreements made by a group of homeowners who have agreed to abide by association rules. *See* Hyatt, *Community Associations: How to Draft Documents That Work*, 7 REAL EST. L.J. 26, 35 (1978) [hereinafter cited as Hyatt, *Community*]. Under I.R.C. § 528(c)(1) homeowners associations include both residential real estate management associations and condominium management associations. Residential real estate management associations consist of owners of houses or housing units within a subdivision, *id.* § 528(c)(3), while condominium management associations consist of owners of condominium units within a condominium complex. *Id.* § 528(c)(2). Owners of both types of units become members of their homeowners association and submit to its authority due solely to the ownership of a residential unit within a subdivision or condominium complex. *See* Hyatt, *Condominium and Home Onwer Associations: Formation and Development*, 24 EMORY L.J. 977, 980 (1975) [hereinafter cited as Hyatt, *Condominium*]. *See generally* Note *Condominiums: Incorporation of the Common Elements—A Proposal*, 23 VAND. L. REV. 321, 323-24 (1969) [hereinafter cited as *Condominiums*]. A developer usually will create a homeowners association as an added benefit to the ownership of units within his development. A purchaser is required by covenant within the deed to each unit to become a member of the association and abide by association rules. *See* Hyatt, *Condominium*, *supra* at 980. In return, members benefit from the construction, maintenance, and management of commonly shared facilities such as swimming pools, tennis courts, sidewalks, parking lots, and services such as yard maintenance, repair services, and housekeeping services. *See* Garrett, *The Taxability of Condominium Owners' Associations*, 12 SAN DIEGO L. REV. 778, 779 (1975) [hereinafter cited as Garrett].

Associations may finance operations through mandatory periodic dues, fees, and assessments, in addition to special fees for services provided on an individual basis, such as for housekeeping or secretarial service. *Id.* at 781; *see* Cowan, *Working with New Rules for Condominiums, Cooperatives and Homeowners Associations*, 46 J. TAX. 204, 208 (1977) [hereinafter cited as Cowan]. In addition, homeowners associations may operate commercial enterprises such as small shopping centers within the subdivision or charge fees for the public use of association swimming pools, tennis courts, and golf courses. *See* Cowan, *supra* at 208. These outside income sources help to defray the cost of the association to the members and to enhance the value of the association by freeing members of ordinary homeowner chores. *See* Garrett, *supra* at 779.

[3] Homeowners associations may choose to be taxed under I.R.C. § 528 if they meet the requirements of the section. While associations are not required to elect under § 528, they may do so in any year in which they qualify. Prop. Treas. Reg. § 1.528-8, 44 Fed. Reg. 1985, 1988 (1979).

[4] The tax-exempt status offered under I.R.C. § 528(d)(1) relieves electing homeowners associations of federal income tax liabilities on income derived from member dues, fees, and assessments. *See* text accompanying notes 49-52 *infra.*

[5] I.R.C. § 528(d)(1) employs the term "Exempt Function Income", *id.* § 528(d)(3), to define income which is exempt from federal income taxation. Only income derived from members of an association in their capacity as owners of residential units may qualify as exempt function income. This income is limited to standardized or pro rated dues, fees, and periodic assessments. Revenues received as payment for special services, such as yard maintenance or secretarial services, are excluded. Similarly, amounts received from outside sources, such as income from non-members and income from commercial operations, are excluded.

provided they meet the requirements of section 528 of the Internal Revenue Code (IRC).[6] The tax-exempt status, however, merely lends additional flexibility to the financing of association expenditures[7] by permitting electing associations to assess members uniformly over a period of years. In contrast, to avoid federal income taxation, nonelecting associations must assess members only when expenses arise.[8] In fact, nonelecting associations may engage in identical association activities with equivalent or lower overall tax liability.[9] This added flexibility is tenuated further by section 528's numerous restrictive provisions[10] which effectively preclude many association activities available to nonelecting associations.[11] In addition, the new section contains confusing and ambiguous language[12] which creates considerable uncertainty regarding compliance with its requirements.[13] Since any noncompliance will result in disqualification under the section,[14] electing associations may be unable to determine their exempt status until the completion of an audit[15] or the expiration of the statute of limitations,[16] either of which will define taxpayer liability. Although the benefits of section 528 have been needed for some time, few associations are likely to deem the limited tax-exempt status worth the cost of the section's restrictions and uncertainties.

The tax-exempt status offered by section 528 is intended to alleviate the historical inequality between the taxation of homeowners association

H.R. REP. No. 658, 94th Cong., 2nd Sess. 325, 327, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3221, 3223 [hereinafter cited as HOUSE REPORT]; S. REP. No. 938, 94th Cong., 2nd Sess. 393, 396, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3821, 3824-25 [hereinafter cited as SENATE REPORT]; Prop. Treas. Reg. § 1.528-5, 44 Fed. Reg. 1985, 1987 (1979); *see* Cowan, *supra* note 2, at 208.

[6] I.R.C. § 528.

[7] *See* text accompanying notes 53-60 *infra*.

[8] *See* text accompanying notes 31-38 *infra*.

[9] Under I.R.C. § 528(b)(1), (d)(2)(B) & (d)(2)(C), electing associations with outside source income may incur more tax liability than nonelecting associations with identical income since these provisions deny electing associations tax benefits on outside source income available to non-electing associations. *See* text accompanying notes 73-76 *infra*.

[10] I.R.C. § 528(c)(1)(C) limits the amount of association funds that may be spent for tournament prizes, member parties, and other activities unrelated to the maintenance of association property. I.R.C. § 528(c)(1)(D) restricts commercial activities by limiting the amount of outside source income electing associations may receive. *See* text accompanying notes 64-69 *infra*.

[11] *See* I.R.C. § 528(c), (d); text accompanying notes 61-75 *infra*.

[12] *See* I.R.C. § 528(c), (d); text accompanying notes 81-113 *infra*.

[13] *See* note 85 *infra*.

[14] Under I.R.C. § 528, associations falling within the definition of a homeowners association may utilize the section's tax exemption. If an association does not qualify under each of the tests found within the definition, it may not elect a tax-exemption. *See* note 85 *infra*.

[15] *See* Cowan, *supra* note 2, at 206. Typically, the taxation of a taxable entity is finalized upon completion of a tax audit by the Internal Revenue Service (IRS). *Id.* The IRS must conduct such an audit pursuant to the procedures of 26 C.F.R. § 601.105 (1978).

[16] The IRS is precluded from assessment of taxes if it fails to assess within three years of the date of filing of an association's return. *See* I.R.C. § 6501(a). If for any reason an association omits substantial amounts of income from its return, however, the IRS may make assessments within six years. *See Id.* § 6501(e)(1)(A).

members and individual homeowners.[17] Traditionally, these associations have been taxed as profit-making organizations,[18] although most are not profit-oriented.[19] Furthermore, since these associations are owned and operated for the benefit of the member-homeowners,[20] they usually assess members only to meet anticipated expenditures.[21] Consequently, they generally produce no taxable income and incur no tax liability.[22] However, associations frequently over-assess members to accumulate cash reserves for both planned and unforeseen future expenditures.[23] Since these overassessments represent an excess of receipts over expenditures,[24] the United States Tax Court has ruled that such overassessments constitute taxable income.[25] Accordingly, associations retaining overassessments will incur income tax liabilities.[26]

This method of taxing homeowners associations has resulted in the unequal tax treatment of taxpayers.[27] While an individual homeowner may spend his earnings on personal services similar to those provided by homeowners associations without fear of taxation,[28] the association member vicariously may incur a tax if his association's income is taxed. Clearly, an association which is taxed on overassessments will retain fewer available funds to provide services for its members.[29] Therefore, the tax on the association is essentially a tax on the members of the association, depriving them of the full value of their contributions.[30]

To alleviate this inequality, homeowners associations may avoid taxa-

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[17] *See* Cowan, *supra* note 2, at 206; Note, *Federal Income Tax Consequences for Condominium Homeowners: A Request for Equitable Tax Treatment,* 15 SANTA CLARA LAW. 384, 393-94 (1975) [hereinafter cited as *Equitable Tax Treatment*]. *See generally* Garrett, *supra* note 2.

[18] *See* Cowan, *supra* note 2, at 206; *Equitable Tax Treatment, supra* note 17, at 393-94.

[19] *See* Hyatt, *Community, supra* note 2, at 28; Garrett, *supra* note 2, at 782.

[20] *See* HOUSE REPORT, *supra* note 5, at 3222-23.

[21] *See* Garrett, *supra* note 2, at 785-86.

[22] *See id.* at 786-89.

[23] *See* Shapiro, *Commercial Condominiums: Tax Considerations for Unit Purchasers and the Association,* 41 J. TAX. 204, 206 (1974) [hereinafter cited as Shapiro].

[24] Under Revenue Ruling 75-370, 1975-2 C.B. 25, the IRS allowed a homeowners association to consider amounts contributed to specific reserve accounts as contributions to capital, rather than as income. *Id.* at 25. Reserve accounts which were segregated from other association funds and earmarked for a specific purpose were treated as nontaxable capital accounts. *Id.* Reserve accounts established to meet unknown contingencies could not be earmarked and therefore were considered taxable income accounts. *See* Shaprio, *supra* note 23, at 206.

[25] Concord Village, Inc. v. Commissioner, 65 T.C. 142, 158-60 (1975); I.R.C. § 61; *see* Garrett, *supra* note 2, at 788-89. Since over-assessments are treated as ordinary income by the IRS, associations will be taxed on retained overassessments. Id. at 788-89.

[26] *See* Garrett, *supra* note 2, at 788.

[27] *See generally Equitable Tax Treatment, supra* note 17.

[28] An individual homeowner may be defined as the owner of a residential unit, house, or condominium who is not a member of a homeowners association. Any funds spent for the maintenance of his residential unit are not subject to federal income taxation. *See* SENATE REPORT, *supra* note 5, at 3822-23. *See generally Equitable Tax Treatment, supra* note 17.

[29] *See* Brauer, *Federal Income Taxation of the Condominium Management Corporation,* 52 TAXES 196, 200 (1974) [hereinafter cited as Brauer].

[30] *Id.*

tion by accumulating overassessments in capital reserve accounts[31] which the IRS has considered to be nontaxable capital accounts.[32] Funds contributed to these accounts theoretically represent nontaxable contributions to capital under IRC section 118 and not income.[33] Therefore, associations may avoid taxation of overassessments by accumulating excess funds in reserve accounts to be used for future capital expenditures.

Although capital reserve accounts have aided associations in avoiding taxation of overassessments, recent IRS rulings limit considerably the utility of the accounts. In Revenue Ruling 75-370,[34] the IRS required reserve accounts that qualify as section 118 contributions to capital to be segregated from other association funds and earmarked for specific purposes.[35] While associations may have plans for specific future expenditures, assessments for which can be segregated easily, unknown future contingencies requiring significant cash outlays may occur. To avoid large, unscheduled assessments, prudent association managements establish reserve accounts for these contingencies.[36] Because these accounts cannot be earmarked for a specific purpose, overassessments deposited in contingent reserve accounts are considered income to the association.[37] Therefore, the vicarious taxation of homeowners association members still exists, although the use of capital reserve accounts[38] can significantly diminish the inequality.

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[31] *See* Frank, *IRS Takes Harsh Position on Exempting Condominium and Homeowners' Associations,* 44 J. TAX. 306, 306 (1976) [hereinafter cited as Frank]; Snowling, *Federal Taxation of Homeowners' Associations,* 28 TAX LAW. 117, 128-29 (1975).

[32] Rev. Rul. 75-370, 1975-2 C.B. 25.

[33] In Eckstein v. United States, 452 F.2d 1036 (Ct. Cl. 1971), the court held that contributions by owners of a cooperative housing corporation toward the retirement of the principal of a mortgage constituted contributions to capital under I.R.C. § 118 rather than qualified income under § 216. *Id.* at 1048. Parallelling the 80% gross income test of § 216, I.R.C. § 528(c)(1)(B) requires that electing associations derive at least 60% of gross income from member dues, fees, and assessments. Therefore, amounts considered to be contributions to capital in *Eckstein* also should be considered contributions to capital, and not income, with respect to homeowners associations under the 60% gross income test of § 528(c)(1)(B). *But see* Park Place, Inc. v. Commissioner, 57 T.C. 767, 778-80 (1972).

[34] 1975-2 C.B. 25.

[35] In Rev. Rul. 75-370, 1975-2 C.B. 25, a homeowners association had established two reserve accounts, segregated in separate bank accounts. By association agreement, one account was earmarked for replacement of a roof and the other for replacement of an elevator. The IRS acknowledged the capital nature of these accounts and exempted contributions to them from the association's income. *Id.*

[36] An example of a contingent reserve account is a separate savings account consisting of overassessments. There is no specific planned use for the funds since the association cannot predict all future expenses, such as repair of a cracked swimming pool or major equipment repair. If contingent reserve accounts are not established, associations would have to make special assessments to meet every substantial contingency. *See* Brauer, *supra* note 29, at 203.

[37] Under Rev. Rul. 75-370, 1975-2 C.B. 25, to qualify as a capital account a reserve account must be established for the purpose of making some specific capital improvement. *Id.* at 25. Since contingent reserve accounts are established to meet unknown contingencies, they cannot qualify as capital accounts under Rev. Rul. 75-370. *See* Frank, *supra* note 31, at 307.

[38] By using capital reserve accounts, associations may retain overassessments without incurring income tax liabilities. Therefore, associations are subject to taxation only on those overassessments which are not deposited in capital reserve accounts, rather than all overassessments. *See* Frank, *supra* note 31, at 306.

In an additional attempt to alleviate this unequal treatment, homeowners associations have endeavored to claim tax-exemptions under IRC section 501.[39] Generally, section 501 exempts qualifying charitable, educational, religious, and social organizations from federal income taxation.[40] Qualification as a social organization under section 501 permits homeowners associations to overassess their members without incurring income tax liabilities.[41] Although many associations have attempted to gain section 501 exempt status as social organizations,[42] only those associations restricting their activities to the maintenance of community architectural standards have been granted the exemption.[43]

The IRS issued no workable guidelines for associations attempting to gain section 501 status until the publication of Revenue Ruling 74-99 in 1974.[44] The ruling's harsh guidelines, however, prevent most homeowners associations, both condominium management associations and residential real estate management associations, from claiming the exemption.[45] The revenue ruling requires that associations claiming an exemption under section 501 must benefit all members of a recognizable governmental subdivision or community.[46] Since the majority of residential real estate man-

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[39] I.R.C. § 501 exempts homeowners associations from federal income taxation on income derived from membership dues, fees, and assessments, but does not exempt the association from taxation on income from outside sources. I.R.C. § 501(b).

[40] Under I.R.C. § 501, nineteen types of organizations are exempted from federal income taxation. Homeowners associations may qualify under § 501(c)(4), which exempts civic leagues or nonprofit organizations operated exclusively to promote social welfare, or § 501(c)(7), which exempts social clubs. In order to qualify for the exemption, an organization must file an application form (Form 1024) with an IRS district director and obtain approval by a letter or ruling. Treas. Reg. § 1.501(a)-1(a)(2) (1976).

[41] I.R.C. § 501 exempts associations from taxation of income such as dues, fees, assessments, and contributions, but does not exempt unrelated income.

[42] *See, e.g.*, Commissioner v. Lake Forest, Inc., 305 F.2d 814 (4th Cir. 1962); Lake Petersburg Ass'n, T.C.M. (CCH) 1974-55 (1974); Rev. Rul. 75-494, 1975-2 C.B. 214 (attempt to qualify as a "social club" under I.R.C. § 501(c)(7)); Rev. Rul. 74-17, 1974-1 C.B. 130; Rev. Rul. 72-102, 1972-1 C.B. 149; Rev. Rul. 69-281, 1969-1 C.B. 155; Rev. Rul. 65-201, 1965-2 C.B. 170. Generally, the IRS has decided that organizations created to benefit economically homeowners association members lack the necessary requirement of benefitting society in general, as required under I.R.C. § 501(c)(4). *See* Frank, *supra* note 31, at 308; text accompanying note 43 *infra*.

[43] *See, e.g.*, Rev. Rul. 72-102, 1972-1 C.B. 149; Rev. Rul. 69-281, 1969-1 C.B. 155. *See* Frank, *supra* note 31, at 309.

[44] 1974-1 C.B. 131.

[45] Homeowners associations applying for exempt status under I.R.C. § 501 must meet three tests:

> First, the homeowners association must serve a "community" which bears a reasonable, recognizable relationship to an area ordinarily identified as a governmental subdivision or unit. Second, it must not conduct activities directed to the exterior maintenance of any private residence. Third, common areas for facilities that the homeowner's association owns and maintains must be for the use and enjoyment of the general public.

HOUSE REPORT, *supra* note 5, at 3222; *see* Rev. Rul. 74-99, 1974-1 C.B. 131.

[46] Rev. Rul. 74-99, 1974-1 C.B. 131. In Revenue Ruling 74-99, the IRS promulgated no specific test under which a homeowners association may determine whether or not it serves a "community." However, the IRS clearly expanded the definition of "community" under

agement associations benefit only member-owners, who normally do not comprise an entire governmental subdivision, most associations cannot claim the exempt status.[47] Similarly, the area governed by a condominium management association rarely would be considered a separate governmental subdivision since condominium projects generally encompass only limited areas.[48] Consequently, the majority of homeowners associations continue to be taxed on retained overassessments.

In response to the harsh treatment under Revenue Ruling 74-99,[49] Congress enacted legislation[50] intended to equate the taxation of homeowners association members with that of individual homeowners.[51] The resulting provision, IRC section 528, grants electing homeowners associations a tax-exempt status on member-owner overassessments.[52] Income from outside sources, however, continues to be taxed at a corporate rate.[53] Since associations electing under section 528 are not taxed on overassessments,[54] the historically unequal tax treatment of member-owners is alleviated.

The benefits to electing associations and member-owners, under section 528, however, appear to be minimal. The exempt status offers electing associations additional flexibility only in financing association expenditures, since use of capital reserve accounts and rebates no longer is required to avoid taxation.[55] Nonelecting associations still must accumulate funds in segregated and earmarked reserve accounts[56] to escape tax liability. Furthermore, unused overassessments either must be rebated to member-owners or applied to the following year's assessments to avoid taxation.[57] Under the provisions of Subchapter T,[58] these practices allow such associations to treat these overassessments as if they were never received.[59] There-

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Revenue Ruling 72-102, 1972-1 C.B. 149. That ruling granted a § 501 tax exemption to a homeowners association whose central purpose was to maintain architectural standards in a subdivision. The benefits of the association were deemed to benefit the entire community. *Id.* at 149. Under Revenue Ruling 74-99, however, an association must *serve* an entire "community" and bear a reasonable, recognizable relationship to an area ordinarily identified as a governmental unit. 1974-1 C.B. at 131.

[47] *See* Rev. Rul. 74-99, 1974-1 C.B. 131. *See also* SENATE REPORT, *supra* note 5, at 3822-23.

[48] *See* Rev. Rul. 74-17, 1974-1 C.B. 130.

[49] Rev. Rul. 74-99, 1974-1 C.B. 131.

[50] Pub. L. No. 94-455, § 2101, 90 Stat. 1897 (1976).

[51] HOUSE REPORT, *supra* note 5, at 3222; SENATE REPORT, *supra* note 5, at 3822-23.

[52] I.R.C. § 528(a); *see* text accompanying note 54 *infra.*

[53] *Id.* § 528(b)(1).

[54] Since overassessments represent earnings of the association derived from member assessments, *see* text accompanying note 25 *supra*, they are exempt from income taxation under I.R.C. § 528(a).

[55] *See* text accompanying note 56-62 *infra.* In addition to the minor benefit of added financial flexibility, I.R.C. § 528(d)(2)(A) offers a specific deduction of $100. This deduction merely allows electing associations to exclude $100 of outside source income. *See* Cowan, *supra* note 2, at 205.

[56] *See* text accompanying notes 31-38 *supra.*

[57] *See* text accompanying notes 58-62 *infra.*

[58] I.R.C. §§ 1381-1388.

[59] Rev. Rul. 70-604, 1970-2 C.B. 9. Under Subchapter T, I.R.C. §§ 1381-1388 associations

fore, by not retaining overassessments for contingencies, nonelecting associations may engage in activities identical to those of tax-exempt electing associations without incurring tax liability. If nonelecting associations require unplanned expenditures, however, special assessments must be levied against member-owners[60] since no funds have been set aside for contingencies. Through this practice of special assessments, income will not exceed expenditures and a nonelecting association will not incur tax liability. In contrast, electing associations may overassess periodically, retaining funds for either planned or unplanned expenditures, without incurring tax liability.[61] Thus, electing associations may avoid unscheduled assessments, but ultimately must assess the same amounts as nonelecting associations engaging in identical activities.[62] The exempt status, therefore, merely affords electing associations the convenience of avoiding special assessments.

The minor benefit section 528 offers to electing associations is tenuated further by provisions of the section that effectively restrict or forbid many association activities.[63] In order to qualify for the election, associations must satisfy two major tests.[64] The first test restricts the amount of outside source income which electing associations may receive.[65] Qualifying associations may receive no more than 40% of their gross income from sources other than membership dues, fees, and assessments from the owners[66] of residential units.[67] Association income from commercial operations or special services not in the form of dues, fees, or assessments from members is disqualified as outside source income.[68] Under this test, associations must limit public use of their facilities, such as swimming pools or golf courses, since fees received from the public would constitute outside source in-

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may either rebate overassessments or credit them to the following year's assessments, treating the overassesments as if they were not received in the current tax year.

[60] A nonelecting association may rebate overassessments and avoid income taxation on them. Rev. Rul. 70-604, 1970-2 C.B. 9. Furthermore, by establishing segregated and earmarked reserve accounts, *see* text accompanying notes 31-38 *supra*, a nonelecting association may fund future capital expenditures out of current assessments without fear of tax liability. Rev. Rul. 75-370, 1975-2 C.B. 25. These practices, however, make insufficient funds available to meet the association's substantial contingencies, necessitating special assessments.

[61] Under I.R.C. § 528(a), income derived from member assessments is exempted from taxation. Overassessments also represent such exempt association income. *See* text accompanying note 25 *supra*.

[62] *See* Cowan, *supra* note 2 at 205.

[63] *See* text accompanying notes 64-74 *infra*.

[64] *See* I.R.C. § 528(a), (c).

[65] *See id.* § 528(c)(1)(B).

[66] I.R.C. § 528(c)(1)(B)(i), (ii) does not limit "ownership" of residential or condominium units to individuals. Therefore, corporations or partnerships in business to rent condominiums apparently will qualify for the exemption, since assessments received from them are received from owners of residential units. Congress may or may not have intended to include corporations and partnerships. *See generally* HOUSE REPORT, *supra* note 5, at 3221; SENATE REPORT, *supra* note 5, at 3821.

[67] I.R.C. § 528(c)(1)(B).

[68] SENATE REPORT, *supra* note 5, at 3824-25.

come.[69] Similarly, associations maintaining party rooms or other facilities that may be rented by members for a separate fee must restrict the use of those facilities since revenues received from the rentals would not qualify.[70] Consequently, electing associations must carefully limit activities that produce revenues which might cause disqualification under the 60% income test and a loss of the section 528 exemption.[71]

While the first major restriction limits the amount of outside source income that electing associations may receive,[72] the second test restricts association expenditures. Under this test, at least 90% of association expenditures must involve "the acquisition, construction, management, maintenance, and care of association property."[73] Association expenditures for activities such as transportation services and recreational activities may not involve association property if the expenditures are for such items as trophies and prizes or the rental of commercial vehicles. Expenditures not involving association property must be limited severely if the association is to qualify under Section 528.[74] Consequently, associations wishing to gain section 528 status may be precluded from providing many services that they currently provide.[75]

In addition to the restrictions on association activities and expenditures, section 528 contains several costly tax provisions affecting associations with outside source income.[76] Under section 528(a), electing associa-

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[69] *Id.;* Prop. Treas. Reg. § 1.528-9, 44 Fed. Reg. 1985, 1988 (1979); Cowan, *supra* note 2, at 206.

[70] SENATE REPORT, *supra* note 5, at 3824-25.

[71] *See* Cowan, *supra* note 2, at 206.

[72] *See* text accompanying notes 65-71 *supra.*

[73] I.R.C. § 528(c)(1)(C).

[74] Many association activities, such as tennis tournaments or chartered transportation services do not involve association property. The income they would produce, therefore, would not qualify under the 90% test of I.R.C. § 528(c)(1)(C). *See* Cowan, *supra* note 2, at 206.

[75] Electing associations engaged in any outside source operations, such as the operation of a small shopping center, may qualify easier under § 528 by creating a separate entity to manage services that would not qualify under either the 60% income test or the 90% expenditures test. *See* I.R.C. § 528(c)(1)(B)&(C). As an alternative, associations may forego election under § 528 for those years in which they would not qualify. Apparently the Treasury takes the position that there are no restrictions on electing in some years and passing in others. *See* Prop. Treas. Reg. § 1.528-8, 44 Fed. Reg. 1985, 1988 (1979).

[76] In addition to the provisions affecting outside source income, two other tax provisions under I.R.C. § 528(d)(2) may adversely affect electing associations. Under § 528 (d)(2)(B), electing associations are denied net operating loss deductions, which generally are granted to corporations under I.R.C. § 172. Nonelecting associations with net losses may carry those losses back three years, or forward five years, to offset any gains within that period. I.R.C. § 172(b). Therefore, if electing associations have outside source income that varies from year to year, an election under § 528 could increase substantially income tax liabilities on that income. *See* Cowan, *supra* note 2, at 205-06.

In addition to the denial of net operating loss deductions, under I.R.C. § 528(d)(2)(C) special deductions for corporations are disallowed under Part VIII of Subchapter B, I.R.C. §§ 241-250. Under Part VIII, corporations are allowed to deduct from income 85% of dividends received from domestic corporations. I.R.C. § 243(a). Therefore, electing homeowners associations with funds invested in stock will be taxed on 100% of dividends received, in contrast to tions are taxed at the same rate as corporations on their outside source income.[77] Section 528(b), however, denies electing associations the surtax exemption generally available to corporations under IRC section 11(d).[78] This provision substantially augments the tax liabilities of electing associations earning more than $25,000 from outside operations. Corporations are taxed at a rate of 20% on the first $25,000 of net income and at a rate of 48% on additional earned amounts.[79] Under section 11(d), corporations are exempted from the surtax of 26% on the second $25,000 of net income. Thus, a denial of this exemption would cost an electing homeowners association with $50,000 of outside source income $6,500 in additional taxes.[80]

In addition to the adverse tax rates and restrictive provisions encountered by electing associations, section 528 contains confusing and ambiguous language that may cause interpretive difficulties. The phrase "association property,"[81] for example, presents numerous interpretive problems. According to the section, a homeowners association must be organized and operated for the acquisition, management, and maintenance of "association property."[82] Furthermore, it must insure that 90% of its expenditures involve the acquisition, maintenance, and care of "association property,"[83] and must not allow earnings to accrue to the benefit of any individual other than by acquiring, managing, and improving "association property."[84] Consequently, associations need a clear understanding of the phrase "association property" since a slight misinterpre-

a tax on only 15% of dividends received by nonelecting associations. Cowan, *supra* note 2, at 206-07.

[77] I.R.C. § 528(c),(d). Taxation of outside source income under § 528 is not provided for expressly. The section, however, taxes all association income except "exempt function income." *Id.* § 528(d)(3). "Exempt function income" is defined as "any amount received as membership dues, fees or assessments. . ." from member-owners. *Id.* Therefore, any funds received in a form other than owner assessments constitute outside source income. *See* Prop. Treas. Reg. § 1.528-9, 44 Fed. Reg. 1985, 1988 (1979).

[78] I.R.C. § 528(b); *see* I.R.C. § 11(d).

[79] I.R.C. § 11.

[80] *Id.* Section 528 is retroactive for tax years beginning after January 1, 1976. *See* Prop. Treas. Reg. § 1.528, 44 Fed. Reg. 1985, 1986 (1979). An electing association earning $50,000 from outside sources would be taxed at a rate of 20% on the first $25,000 and 48% on the second $25,000. I.R.C. § 11(b),(c). Thus, the tax liability would equal $17,000. In contrast, nonelecting associations would be taxed at a rate of 20% on the first $25,000 and 22% on the second $25,000, since the surtax exemption, I.R.C. § 11(d), would be available to them. Their corresponding tax liability would amount to $10,500 each. Therefore, electing associations could be liable for $6,500 more in taxes than nonelecting associations. *See* Cowan, *supra* note 2, at 206. However, the surtax rate structure has been repealed for tax years beginning after January 1, 1979. I.R.C. § 11.

[81] I.R.C. § 528(c)(4).

[82] Under I.R.C. § 528(c)(1)(A) electing associations must be organized and operated to manage and maintain association property. This is the first of five tests under § 528(c) that electing associations must conform to, and one of three tests that uses the term "association property."

[83] I.R.C. § 528(c)(1)(C); *see* text accompanying notes 69-73 *supra*.

[84] I.R.C. § 528(c)(1)(D) disallows the distribution of any dividends from association earnings if they benefit a member-owner. Improvements to association property by the association, however, are not considered dividends to member-owners. *Id.*

tation could disqualify an unwary association under one of these restrictive tests.[85] Unfortunately, the definition of association property under section 528(c)(4)[86] fails to distinguish adequately between property privately held by association members and property actually owned by the association.[87] Under section 528(c)(4), association property includes "property within the organization privately held by members of the organization."[88] Clearly, not all property "held" by all members can be considered association property since such a conclusion would lead to absurd consequences. An association would obviously be violating the intent of the section by making "improvements" to a member's dining room, automobile, or bank account, since this would be tantamount to paying a dividend to the member-owner in violation of section 528(c)(1)(D).[89] However, the Code,[90] proposed regulations,[91] and legislative history[92] offer little guidance in determining what property held by members constitutes association property. Apparently, only privately "held" property directly affecting the general appearance of the association in some manner may fall within the

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[85] A slight misinterpretation of the term "association property" may cause an electing association to make expenditures that fail to qualify under the 90% expenditures test of § 528(c)(1)(C). *See* text accompanying notes 72-75 *supra.* If an association cannot qualify under the expenditures test, it would not come within the definition of a homeowners association under § 528(c) and would not qualify for tax-exempt status. I.R.C. § 528(a). For example, if an association mistakenly believes that expenditures for plumbing repairs in member's residences qualify under the expenditures test of § 528(c)(1)(C), the association might spend 11% of all association expenditures for the year on plumbing repairs. Unfortunately, since plumbing would not qualify as association property, such repairs would not qualify, *see* SENATE REPORT, *supra* note 5, at 3824-25, and the association could not meet the expenditures test. Therefore, the association would not fall within the definition of a homeowners association, I.R.C. § 528(c), and could not qualify for the tax-exemption. *Id.* § 528(a).

[86] I.R.C. § 528(c)(4).

[87] Prop. Treas. Reg. § 1.528-3, 44 Fed. Reg. 1985, 1986-87 (1979) provides some insight into the definition of "association property." First, association property "must be available for the common benefit of all members of the organization and must be of a nature that tends to enhance the beneficial enjoyment of the private residences. . . ." *Id.* Second, areas set aside for nonmember use, or areas used primarily by nonmembers, are not considered to be association property. *Id.* Third, property normally owned by a government unit such as roads, parks, sidewalks, firehouses, health facilities, and safety and welfare facilities, is considered to be association property. *Id.* Finally, the proposed regulation offers a cursory review of association property held privately by members. Only property that affects the overall appearance of the residential units which make up the organization, such as exterior walls and roofs of privately owned residences, will qualify as association property if:

> (1) There is a covenant relating to exterior appearance that applies on the same basis to all such property;
>
> (2) There is a pro rata mandatory assessment (at least once a year) on all members of the association for maintaining such property; and
>
> (3) Membership in the organization is a condition of ownership of such property.

Id.

[88] I.R.C. § 528(c)(4)(C); Prop. Treas. Reg. § 1.528-3(c), 44 Fed. Reg. 1985, 1987 (1979).

[89] I.R.C. § 528(c)(1)(D).

[90] *See* I.R.C. § 528(c)(4).

[91] *See* Prop. Treas. Reg. § 1.528-3, 44 Fed. Reg. 1985, 1986-87 (1979).

[92] HOUSE REPORT, *supra* note 5, at 3224-25; SENATE REPORT, *supra* note 5, at 3825.

definition.[93] Consequently, the illusory definition of association property under section 528(c) may cause the disqualification of unsuspecting associations under the 90% expenditures test,[94] and forfeiture of their exempt status.[95]

Further confusion under section 528 exists with regard to the language used to define the 60% gross income test[96] and 90% expenditures test.[97] The 60% test parallels the 80% gross income test found in IRC section 216,[98] which deals with cooperative housing corporations.[99] Under that test, 80% of the gross income of a cooperative housing corporation must be derived from tenant-shareholder lease payments.[100] However, amounts used to retire mortgage indebtedness, although originally contributed by tenant-shareholders, do not qualify as income under the 80% test since these amounts constitute contributions to capital.[101] Apparently, amounts used for capital improvements also would not qualify under the 60% test of section 528.[102] The Senate Committee Report on section 528 initially adopted this approach of disqualifying funds used for capital improvements,[103] but stated curiously that fixed annual assessments used for the construction of improvements on association property would qualify as income under the 60% test.[104] Consequently, electing associations may not

[93] *See* Cowan, *supra* note 2, at 207. There has been no discussion in either the proposed treasury regulations, Prop. Teas. Reg. § 1.528, 44 Fed. Reg. 1985 (1979), or the House and Senate reports, note 5 *supra*, as to whether privately owned shrubbery, flowers, windows, walkways, or lawns qualify as association property. If such property qualifies, association expenditures for its maintenance would qualify under the 90% expenditures test. *See* I.R.C. § 528(c)(1)(C).

[94] *See* note 85 *supra*.

[95] *See id.*

[96] I.R.C. § 528(c)(1)(B).

[97] *Id.* § 528(c)(1)(C).

[98] *Id.* § 216(b)(1)(D) requires that cooperative housing corporations, *see* note 99 *infra*, receive at least 80% of total income in the form of lease payments from tenants.

[99] A cooperative housing corporation commonly is created by a commercial developer or group of individuals for the purpose of renting residential units on a cooperative basis. Once formed, the corporation sells its shares to individuals who simultaneously contract to lease one or more residential units from the corporation. The corporation finances all of the units through one mortgage to be retired through profits earned from lease payments by the shareholder-lessees. After final payment of the mortgage, the shareholder-lessees will own their units outright. This type of financing is the primary benefit of the cooperative arrangement. *See generally* Comment, *Cooperative Apartments and the UCC*, 29 WASH. & LEE L. REV. 189 (1972).

[100] I.R.C. § 216 allows shareholder-lessees to deduct from personal income the portion of property taxes and interest on the mortgage attributable to their residential unit.

[101] Eckstein v. United States, 452 F.2d 1036, 1048-49 (Ct. Cl. 1971).

[102] Under the rationale of Eckstein v. United States, 452 F.2d 1036 (Ct. Cl. 1971), assessments used to retire association mortgages or to purchase capital assets do not qualify under the 60% gross income test since these amounts represent contributions to capital. *Id.* at 1048. *But see* Prop. Treas. Reg. § 1.528-9, 44 Fed. Reg. 1985, 1988 (1979).

[103] SENATE REPORT, *supra* note 5, at 3824-25. Amounts that qualify for the 60% test may not include assessments intended for capital improvements since these funds would be considered capital contributions to the association rather than income. *Id.* at 3824.

[104] *Id.* The Proposed Regulations further confuse the ambiguous language of I.R.C. §

be certain of satisfying the 60% income test if expenditures for capital improvements total more than 40% of association income.

A similar uncertainty exists with respect to the 90% expenditures test.[105] Expenditures for capital improvements[106] and maintenance of exterior walls and roofs of member-owners qualify under the test,[107] since both roofs and exterior walls are association property as defined by section 528(c)(4).[108] In contrast, contributions to reserve accounts, which constitute the funds to be used for future maintenance or improvements on association property, do not qualify.[109] The Senate intimated, however, that funds from reserve accounts employed for improvements on association property will qualify under the 90% test at the time of their use.[110] With respect to improvements financed through the use of mortgage indebtedness, neither the Senate nor House of Representatives indicated when mortgaged funds would qualify under the test.[111] Thus, in light of the section's confusing language, electing associations should carefully consider first, what type of income and expenditures will qualify under the respective tests and second, when expenditures will qualify. Electing associations, however, may never know if they qualify under the section until the completion of an audit[112] or the expiration of the statute of limitations.[113]

While section 528 creates considerable interpretive difficulties, the original unfair tax treatment of member-owners has been ameliorated by the section's tax-exemption provisions.[114] Member-owners of electing associations no longer face vicarious double taxation. Despite the accomplishment of congressional intentions, however, section 528's strict regulation of electing associations places unacceptable limitations on association activities[115] and inequitably imposes higher taxes on those associations with outside-source income.[116] Since the primary tax consideration revolves around the

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528(c)(1)(B) by stating that income under the 60% test must be exempt function income, Prop. Treas Reg. § 1.528-5, 44 Fed. Reg. 1985, 1987 (1979), which does not include assessments for capital improvements. *Id.* § 1.528-9(a), 44 Fed. Reg. 1985, 1988-89 (1979). Therefore, under the proposed regulations, assessments ultimately spent on capital improvements would not qualify despite the language of I.R.C. § 528(c)(1)(B) which clearly states that assessments received from owners will qualify under the test.

[105] I.R.C. § 528(c)(1)(C); *see* text accompanying notes 73-75 *supra.*

[106] I.R.C. § 528(c)(1)(C); SENATE REPORT, *supra* note 5, at 3824-25; Prop. Treas. Reg. § 1.528-6(a), 44 Fed. Reg. 1985, 1987 (1979).

[107] Prop. Treas. Reg. § 1.528-6, 44 Fed. Reg. 1985, 1987 (1979).

[108] I.R.C. § 528(c)(4).

[109] SENATE REPORT, *supra* note 5, at 3825; Prop. Treas. Reg. § 1.528-6(a), 44 Fed. Reg. 1985, 1987 (1979).

[110] SENATE REPORT, *supra* note 5, at 3825.

[111] HOUSE REPORT, *supra* note 5, at 3224; SENATE REPORT, *supra* note 5, at 3825.

[112] *See* Cowan, *supra* note 2, at 206; *note* 15 *supra.* Audit procedures may be found in 26 C.F.R. Part 601, § 601.105 (1978).

[113] I.R.C. § 6501(a); *see* note 16 *supra.*

[114] *See* text accompanying notes 63-75 *supra.*

[115] *See* text accompanying notes 76-79 *supra.*

[116] *See* text accompanying notes 31-38 *supra.*

tax treatment of contingent reserve accounts,[117] Congress can remedy the inequality simply by allowing homeowners associations to accumulate overassessments in contingent reserve accounts and treat them as non-taxable capital accounts. This is essentially what Section 528 accomplishes indirectly, with restrictions, embodied in the section, intended to prevent abuse of the tax exemption by commercially-oriented associations.

Since accumulations in contingent reserve accounts represent earnings of the association, a stipulated condition precluding distributions of association cash to any person, other than in the form of rebates, could prevent abuse by commercially-oriented associations. Such a provision would equalize the tax treatment of the individual homeowner and the member homeowner, thereby accomplishing congressional intent while avoiding the harsh results inherent in the section's provisions.

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[117] Under I.R.C. §§ 1381-1388 membership associations may rebate overassessments, treating them as if they were never received. *See* Cowan, *supra* note 2, at 205.